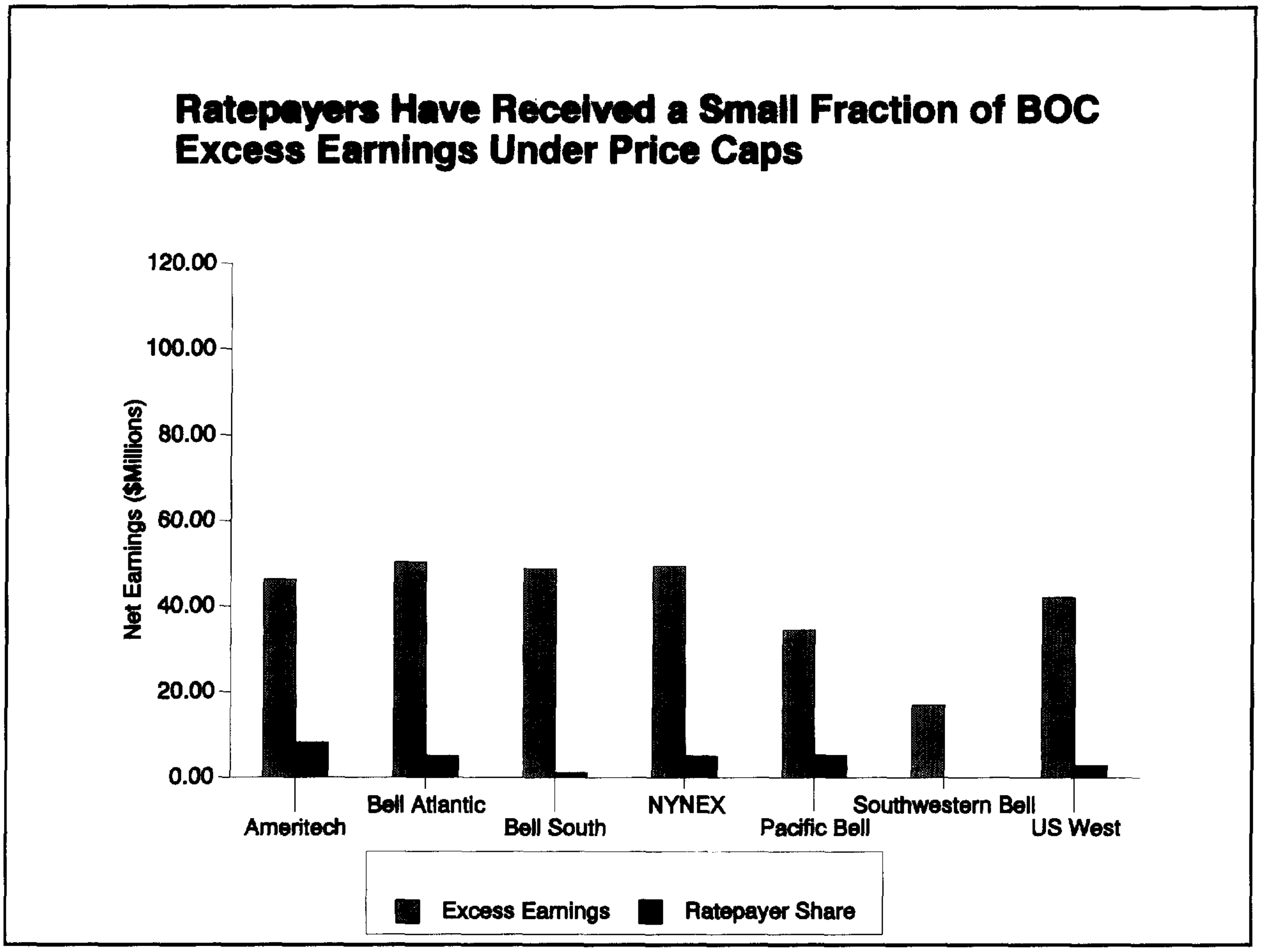

Figure 3 — Bell Operating Company Excess Earnings in 1992

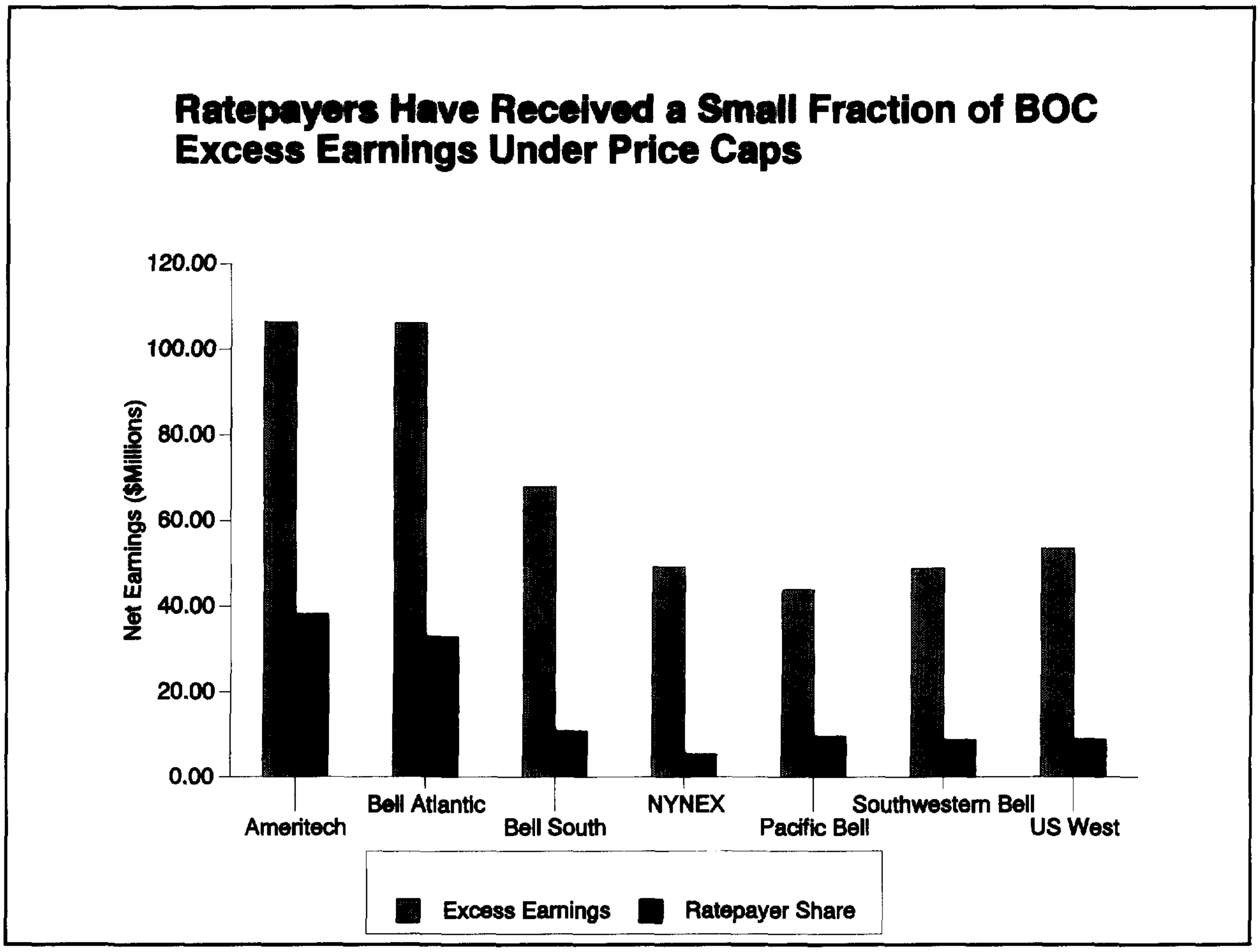

Figure 4 — Bell Operating Company Excess Earnings in 1993

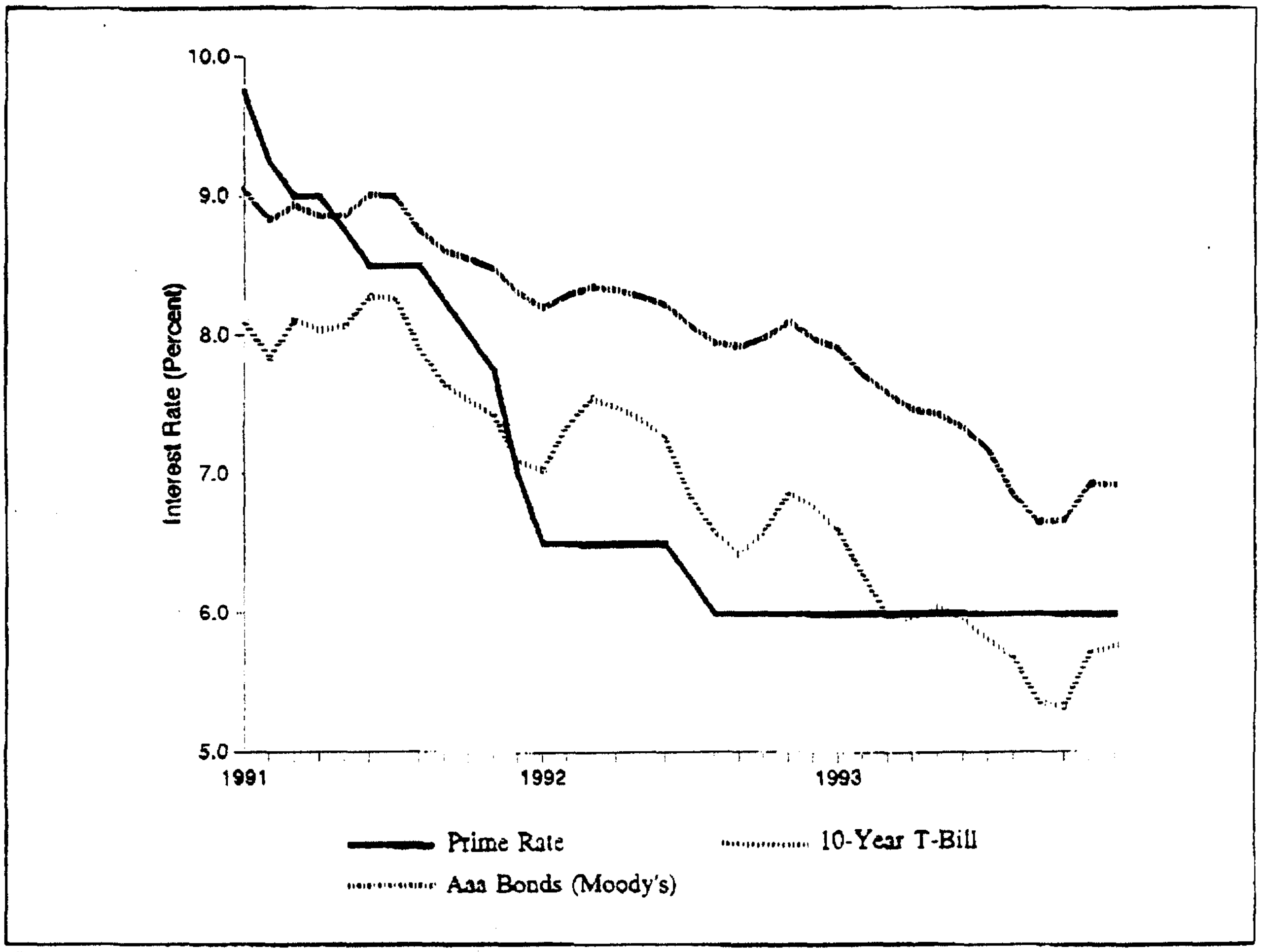

Figure 5 — Decline in Interest Rates Over Past Three Years

Baseline Issue 5: The Balanced 50/50 Formula

Baseline Issue 5a: Whether the Commission should reconsider its use of the Balanced 50/50 formula to cap common line charges.

Baseline Issue 5b: If so, what method should the Commission use to cap common line charges?

Baseline Issue 5c: If the Commission were to adopt a per-line charge, how should this affect possible changes in the productivity factor or the composition of baskets, *e.g.*, changes such as the inclusion of common line rates in a public policy basket?

Baseline Issue 5d: What incentives are generated by the current Balanced 50/50 formula, the per line formula, or other possible formulas? What incentives should the formula seek to generate?

The Commission should be cautious regarding any changes in its original well-thought-out and balanced compromise.

In the LEC Price Cap Order, the Commission adopted a formula to cap non-traffic sensitive access rates because of the unique characteristics of the carrier common line charge.[130] In essence, this approach divides the benefits of demand growth between LECs and the interexchange carriers. The Commission described this is a reasonable compromise which split the incentives evenly in the absence of data which could identify the exact sources of demand growth.[131]

The Commission now asks whether there is any data which would cause it to refine this split. We have not seen any evidence that would suggest a change at this time. We believe that the Commission should look closely at submissions in this area and that it should be cautious regarding any changes in its original well-thought-out, balanced compromise.

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130. *NPRM* at para. 56.

131. *Id.*, para. 58.

Baseline Issue 6: Exogenous Cost Changes

Baseline Issue 6a: Whether the number of cost changes currently eligible for exogenous treatment under price caps should be reduced.

The scope and nature of exogenous cost adjustments should be further limited.

The Commission's tentative decision to narrow the scope of cost changes that would be considered for "exogenous treatment" under the Price Cap rules is fundamentally correct and should be adopted. As observed in the *NPRM*, the Commission has already made refinements to the standards for allowable exogenous cost adjustments, most notably in introducing a two-pronged test for whether a change in Generally Accepted Accounting Principles (GAAP) rules should be reflected in a price cap adjustment.[132] In order for the price cap mechanism to closely emulate the functioning of a competitive market, the exogenous cost standard should be limited so as to exclude all but those economic cost changes that are directly attributable to well-defined regulatory actions affecting local exchange carriers specifically and uniquely.

The Commission's original intent and purpose in permitting upward or downward exogenous adjustments to the price cap index was to avoid unjustly rewarding or punishing carriers for cost changes that could not be attributed to changes in the carrier's efficiency.[133] This basic goal remains valid, but it is critical that it be applied in the context of how a competitive firm would have to respond to the types of cost changes that are at issue. In considering any proposed exogenous or "Z-factor" adjustment, the key question before the Commission should not be the magnitude of the direct impact on the LEC of the cost change *per se*, but rather how a cost change of that same type is likely to be responded to by nonregulated firms operating in competitive industries. In competitive markets, individual firms have little opportunity to pass through, dollar-for-dollar, the impact of "unforeseen" cost changes that may be "beyond management's control" to their customers. If the "unforeseen change" has a broad economic impact (such as, for example, an increase in federal payroll tax rates or mandated accounting changes such as SFAS 106 with respect to post-retirement benefits other than pensions), its effects should be captured in the general inflation index GDP-PI which would, in turn, flow through to the price cap index. If, on the other hand, the "unforeseen cost change" is localized geographically (e.g., a change in state tax rates, local

132. *NPRM*, para. 62, citing Treatment of Local Exchange Carrier Tariffs Implementing Statement of Financial Accounting Standards, "Employers Accounting for Postretirement Benefits Other Than Pensions," 8 FCC Rcd 1024, 1033, released January 22, 1993 (OPEBs Order).

133. *NPRM*, para. 60.

building codes, or even a natural disaster), an individual firm operating in competitive markets would have limited ability to raise prices where its competitors were not themselves similarly impacted. Either way, no automatic flow-through would occur, and none should be permitted under the Commission's price cap rules.

LECs have in the past argued that even if a cost change is captured to some degree in the general inflation index, they should nevertheless be entitled to a Z-adjustment to the extent that the impact of the event *upon LECs* is *disproportionate* to the overall inflation index. Such an argument was, for example, advanced by the RBHCs in support of their request for Z-adjustment treatment of the post-retirement benefits accounting change (FAS 106).[134] The problem, of course, with permitting "disproportionate" effects to be treated as Z-adjustments is that by their very nature individual changes in cost (relative to overall inflation) are disproportionate *in both directions*. Indeed, by definition, an economy-wide inflation index is an *average* of all such changes which, individually, will be both greater and less than the overall rate of inflation. If LECs are permitted to claim exogenous cost treatment where a specific cost change exceeds GDP-PI, then they (or someone) must assume responsibility for capturing and calculating all situations in which the effect of the cost change is disproportionately *less* than the change in GDP-PI. As the Commission has recognized, LECs cannot be relied upon to undertake this responsibility (see the following discussion), and the Commission would require a substantial commitment of resources to initiate a continuing program to undertake this effort on its own. Accordingly, the only type of cost change that should be considered for Z-adjustment treatment is one which results from regulatory actions that uniquely and specifically affect local exchange carriers. Examples of such changes would be jurisdictional cost shifts (between the state and federal books) and certain other accounting type changes.[135]

An overly-broad definition of allowable exogenous costs exacerbates the intrinsic bias in the process of identifying and adjusting for exogenous cost changes, that favors the LECs and works to the disadvantage of ratepayers.

In the *NPRM*, the Commission has expressed concern that it is difficult to identify all of the cost changes that may be relevant to an exogenous adjustment, and that LECs have "substantial incentives to report and request exogenous treatment only for those [changes] that

134. OPEBs Order, para. 62.

135. For example, the Commission should continue to require LECs to make an appropriate exogenous adjustment whenever a Commission-approved amortization has expired, as it did in the case of carriers' reserve deficiency amortizations. "In the Matter of 1992 Annual Access Tariff Filings" et. al., *Memorandum Opinion and Order Suspending Rates and Designating Issues for Investigation*, CC Docket 92-141, released June 22, 1992, paras. 29-34.

might generate increases in the cap, not those that might justify reductions."[136]
The combined effect creates a serious obstacle to the appropriate disposition of exogenous cost changes. In general, the exogenous events which would tend to *increase* the LECs' costs are readily identifiable, direct in their effects, and relatively large. In contrast, the events which would lead to cost *decreases* for LECs are often indirect, far more difficult to identify, and individually small, even though their cumulative effects can be substantial. These conditions produce a strong upward bias in the exogenous cost adjustment mechanism, that works to the advantage of the LECs and against the interests of ratepayers.

The bias can be seen by considering how increases in state tax rates are likely to be treated under the existing exogenous cost rules. Suppose that an increase in state tax rates (income, payroll, or property, for example), occurs in a large state, such as California. An increase in California tax rates would have a small, but perceptible, impact upon GDP-PI, roughly in proportion to California's share of the total US economy. A LEC operating solely or primarily in that one state (e.g., Pacific Bell) would (if permitted) likely seek an upward exogenous cost adjustment, on the grounds that the tax increase would not be fully captured in the GDP-PI.

However, for that very same reason, tax changes occurring in other states would similarly impact GDP-PI *but would have no direct or consequential effect upon the California LEC's costs*. For example, a state tax increase in New York would (if inflationary) result in a small increase in GDP-PI (reflecting New York's proportionate share of the national economy), which would in turn result in a small increase in the *California* LEC's GDP-PI-based price cap index. Here, however, the effect of the *New York* tax change would affect the California LEC disproportionately *less* than the GDP-PI. If an upward Z-adjustment is allowed for tax rate increases in the home state, then downward Z-adjustments must be made whenever a tax increase occurs anywhere outside of the home state. Failure to do this would result in the *California* LECs enjoying a *windfall increase* in the price cap due to the effects of the New York tax increase on the GNP-PI. Unless the Commission is prepared to deal with this level of detail, it must reject categorically all Z-adjustments based upon disproportionate impact.

136. *NPRM*, para. 65.

Baseline Issue 6b: If so, which cost changes should be eligible for exogenous treatment under price caps.

A strict definition of allowable exogenous adjustments is an essential step in transitioning the LECs toward the exigencies of a more competitive marketplace.

It is not difficult to anticipate that the BOCs and other LECs will strenuously oppose any narrowing of the definition of allowable exogenous cost changes from what they have enjoyed to date. The companies will no doubt protest that excluding certain types of exogenous changes from consideration will saddle them with cost increases that are beyond their control, and decrease their ability to undertake internal cost reductions and productivity improvements. At the same time, however (and no doubt in the same Comments), they will call for modifications to the price cap regime to increase their pricing flexibility, to permit them to unilaterally set depreciation lives and rates, reduce or eliminate their sharing requirements, and the like, in order to respond to an increasingly competitive environment.

In a competitive market, firms simply do not get the kind of cost protection that the LECs seek through Z-adjustments, and adherence to the overriding competitive result objective simply does not permit the kinds of government or regulatory "bail outs" that such flow-throughs create. A well-managed firm should be capable of planning for and dealing with the very kinds of contingencies and uncertainties that the LECs seek to portray as "beyond their control." In point of fact, most businesses face a myriad of conditions that are "exogenous" and "beyond management's control" every day. LECs are entitled to no more protection than would be any firm operating under competitive conditions. LECs can protect themselves by purchasing insurance, by maintaining reserve funds for contingencies, by effective and detailed forecasting and planning, and by taking other actions that are by any definition *well within management's control*. Just as a life insurance company, by relying upon mortality tables, can develop a fairly good forecast of *how many* of its policyholders will die but without knowing precisely which specific individuals those will be, a well-managed firm can know *for certain* that unforeseen events beyond its control will happen — the infamous "Murphy's Law" — if anything can go wrong, it will go wrong. The relevant and appropriate test for Z-adjustment treatment is whether the particular *category* of event could have been anticipated and accounted for by management, not whether the specific event could have been predicted in advance. And on that basis, few if any so-called "exogenous" conditions would ever qualify for an automatic flow-through to ratepayers.

The "competitive result" goal of economic regulation in general and of the LEC Price Cap Plan in particular requires nothing less from LECs: they will have to deal with these events in the same manner as any other firm, i.e., figure out a way to absorb them, work around them, or suffer a short-run earnings decrease. It is completely reasonable and appropriate, in the context of incentive regulation, for LECs to take responsibility for forecasting and dealing with such unanticipated and (arguably) extraordinary cost changes.

Baseline Issue 6c: Whether we should adopt an administrative process to allow access customers or other groups to request cost changes eligible for exogenous treatment and, if so, what should be the procedures in such an administrative process?

The Commission's proposal to establish an administrative process that would permit access customers or other groups to request consideration of potential exogenous cost adjustments is appropriate.

As demonstrated above in response to Baseline Issue 6a, there is a strong bias in the selection process for candidate adjustments that works against the identification of exogenous cost changes that would lower the price cap. This bias could be somewhat reduced — although not entirely eliminated — by creating a specific opportunity for non-LEC parties to bring to the Commission's attention countervailing cost changes that might not otherwise be recognized.

The most straightforward course would be for the Commission to solicit proposed exogenous changes from all parties in the comment cycle on access tariff filings requirements that has traditionally preceded LECs' annual access filings. Any proposed changes that were relatively simple or uncontroversial could then be incorporated into the initial access filings without delay, while the remainder could be investigated further as needed. This approach would create a minimum amount of additional administrative burden on the Commission and all parties.

In addition, we propose that the Commission create specific incentives to encourage LECs to submit unbiased proposals for exogenous cost adjustments. If the Commission adopts a particular Z-factor adjustment that had been proposed by a non-LEC party where that adjustment had not been previously raised by the LEC, there should be a penalty provision that increases the effective size of the negative Z-factor adjustment. For example, the Commission could assess a fine equal to the amount of the Z-adjustment that had been omitted by the LEC. The presence of such a penalty provision would help to induce LECs to recommend the appropriate Z-factor adjustments, both positive and negative.

While these measures would be worthwhile to incorporate into the LEC price cap plan, it remains the Committee's view that the most effective response to the bias problem is to apply the more stringent standard for allowable exogenous adjustments that is described above. Providing other parties with a well-defined opportunity to propose exogenous adjustments does not in itself correct the fundamental asymmetry in the exogenous cost mechanism, since it would remain the case that no single individual non-LEC party would have a sufficient economic incentive to research, identify and affirmatively argue for exogenous adjustments that benefit the general body of ratepayers. Similarly, the penalty provision could not entirely foreclose the possibility that a LEC would find it in its economic self-interest to neglect to report those exogenous cost changes that would most benefit ratepayers.

Baseline Issue 7: Service Quality, Infrastructure Monitoring and Network Reliability

Baseline Issue 7a: Whether the Commission should increase or revise monitoring of the LECs' network reliability, service quality and infrastructure development. Commentors are requested to submit data, information, and proposals in this inquiry that their view will contribute to assuring state-of-the art reliability, service quality, and infrastructure development for the LECs. Commentors are also requested to submit data identifying the administrative and business costs associated with their proposals.

Baseline Issue 7b: Whether and if so how the Commission should expand it service quality monitoring to include price cap LEC facilities and services that may be interconnected with the local exchange network or used to provide similar capabilities including wireless services and coaxial cable. Commentors are requested to submit specific data on the administrative and business costs associated with their recommendations on the reporting requirements.

The Commission must continue to closely monitor service quality and infrastructure development.

Society's use of telecommunications services is growing and evolving. The network technology that both stimulates and serves this growing and evolving demand is changing at a relatively rapid rate. Thus, a situation exists in which our society relies increasingly upon telecommunications, and the technology used to satisfy this demand is being introduced and changed at a particularly rapid rate. Under these circumstances, the Commission should continue to monitor the performance of the nation's telecommunications network.[137]

The Commission must be prepared to determine whether the nation's telecommunications network is satisfying changing demand, in terms both of quantitative and qualitative changes. An effective monitoring program, if properly designed, could serve as an early warning system — so to speak — of network deficiencies. Even the most effective monitoring program, however, does not guarantee against network failures. Such a program, however, puts the Commission in a position to respond quickly to network failures or problems which

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137. The "network" in this context embraces all public telecommunications resources irrespective of the entity responsible for their deployment, management, or the provision of services derived therefrom. In terms both of aggregate revenues and numbers of directly-connected participants, however, the national network remains dominated by regulated local exchange carriers.

do not rise to the failure level. Given the importance of telecommunications to our society and economy, anything less could understandably be considered regulatory irresponsibility — just as some would argue that elements of the government failed in their responsibility to adequately monitor the operations of thrift institutions in the 1980s.

Maintenance of adequate service quality does implicate the Commission's price cap plan in a more direct way. A carrier's decision to operate under price caps does not, of course, relieve the carrier of its obligation to maintain what the Commission considers to be an adequate level of service quality. A Commission finding that a carrier's service quality is inadequate should not qualify as an exogenous cost condition under the price cap rules.

As discussed in response to General Issue 1, the price cap regime is supposed to reflect, better than RORR, competitive market dynamics. But in a competitive market, individual providers must maintain adequate service quality or suffer lost business or legal consequences if their failure to do so violates contractual, statutory or common law requirements. Nothing short of that should be demanded or expected of price cap LECs, and price cap LECs should not be permitted to recover as exogenous adjustments to their Price Cap Indices costs which they incur voluntarily or pursuant to regulatory directive in order to maintain adequate service quality. In this context, adequate service quality is not a concept without boundaries. The meaning of adequate service quality should be keyed to the level of service that would reasonably be expected in an effectively competitive marketplace. This standard is elastic but reasonable. Indeed, under section 201 of the Communications Act, carriers are required to honor reasonable requests for service and to maintain reasonable practices. Failure to maintain adequate service quality or to respond reasonably to qualitatively different demand would violate the requirements of the Communications Act and certainly not replicate the operation of the competitive marketplace.

With respect to the nature of the monitoring activity itself, we would note that many LEC actions affecting service quality may involve a considerable period of latency between the time that a particular cost is incurred (or avoided) and the time that the effects of that action materialize in terms of observable performance. A price cap LEC, confronted with economic incentives to minimize current operating costs, may choose to postpone or perhaps avoid altogether certain preventive maintenance activities. Such a decision may have a deleterious impact upon service quality, but perhaps not for some time after the cost-cutting action is taken. In developing a monitoring system, the Commission needs to examine ongoing expenditures on maintenance, plant expansion, redundancy, and other quality-impacting actions in addition to regular examination of "current" service quality indicators *per se*. Significant deviations from previous expenditure patterns may provide an early warning of problems ahead, and at a minimum should be examined and explained as part of the Commission's ongoing monitoring activities.

Baseline Issue 8: Rates and Regulations for New Services

Baseline Issue 8a: Whether the LEC price cap new services requirements impose unnecessary regulatory impediments to the development and introduction of new services with specific identification of what those impediments are and an assessment of their magnitude.

The new service requirements do not impose an unnecessary regulatory impediment to the development and introduction of new services. Rather, they protect monopoly ratepayers who have no alternative but the LEC for purchasing such new services.

The simple answer to this question is unequivocally no. New services very likely will be offered as *de facto* monopoly offerings, particularly when provided over the public switched telecommunications network. In the absence of effective competition, only effective regulation prevents monopolists, like the LECs, from gouging captive ratepayers. Pursuant to section 201 of the Communications Act, carriers are required to honor reasonable requests for service. Obviously, such requests can be for new services, services for which there is not a realistic alternative. The Commission has recognized as much by requiring the BOCs to offer Open Network Architecture services that are technically and economically feasible to provide. If there were realistic alternatives, the Commission could have observed, but did not observe, that non-LECs could turn to alternative providers of local exchange service for such new functionalities. If there realistically are alternative vendors of such functionalities, the Commission, and end users such as the members of the Ad Hoc Committee, could count on the marketplace to establish reasonable rates. Regulatory oversight would be unnecessary; indeed, it would be wasteful. Realistically, such vendors do not exist at this time.

None of the existing regulatory requirements applicable to new service offerings made by price cap LECs are unnecessary. The existing cost support requirements applicable to new services are not onerous. One need only be familiar with the virtually nonexistent cost data that the BOCs submitted to support their rates for 800 Database vertical features.[138] Nor can such carriers reasonably assert that justification of risk premiums has been an onerous undertaking. To the extent the carriers have even attempted to make such showings, the showings have been cursory and largely accepted by the Commission.

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138. Indeed, it is respectfully suggested that the Commission staff personnel responsible for formulating policy recommendations to the Commission with respect to this docket consult with the personnel in the Commission's Tariff Division who have reviewed the cost data that price cap LECs have submitted to support proposed rates for 800 Database Service vertical features.

Without at least the existing level of cost support, price cap LECs would be free to set rates for new services at levels which serve their strategic business purposes, without regard to whether such rates are just and reasonable under the Communications Act. They could use pricing to effectively delay or prevent the utilization of new functionalities, even though they might be required to offer them. Such a result is not far-fetched: It would in fact be quite possible if the Commission were to reduce or eliminate the information that price cap LECs must submit to justify rates for new services.

The same undesirable outcome could occur if the Commission were to delay the time for submission of such cost support material until the new services would come under the price cap constraints. This result is undesirable because end users could be effectively denied functionalities that would allow them to operate more efficiently and contribute to economic growth; and potential competitors to the LECs could be effectively denied utilization of functionalities which they would use to compete with the LECs. Such functionalities could be something as straightforward as access to call control functionalities that would be used to control traffic on lines presubscribed to the LECs' competitors but still physically provisioned by the LECs. Surely the Commission would not want its pro-competitive policies to be undermined by such tactics, but that is likely what would happen if the Commission reduces or eliminates the cost support requirements for new services offered by price cap LECs.

Baseline Issue 8b: Whether and how we should modify the LEC price cap new services procedures and cost support rules to ensure that these rules advance our goals of encouraging innovation and setting reasonable rates.

Granting price cap LECs additional pricing flexibility by modifying the new services procedures and cost support rules is not likely to significantly enhance the level of innovation the access service market.

Again, the answer must be an unequivocal "no." Nothing in the existing rules prevents price cap LECs from innovating, and indeed they are expected to do so by virtue of the incentives that price cap regulation is supposed to create. Innovation by price cap LECs should not, need not and cannot be encouraged by a regulatory approach that would produce rates for new services which are not just and reasonable. The Commission should not encourage innovation which subjects end users to exploitative rates. As long as the LECs are at least *de facto* monopolists, the Commission cannot count on marketplace forces to drive rates for new services to reasonable levels. Once established, rates for monopoly services can continue to earn exploitative returns.

Moreover, implicit in the Notice seems to be the notion that innovation will be significantly accelerated by giving price cap LECs additional pricing flexibility. If such a notion exists, it is a profoundly mistaken idea. Lowering barriers to entry, facilitating interconnection of competing carriers at the physical and logical levels, assuring that the rates for monopoly service functionalities that would facilitate the emergence of competition are reasonable, and generally adopting a competition friendly regulatory program, will do far more to promote innovation than would granting price cap LECs pricing flexibility that they could use to inhibit the development of competition at the local level, and thus retard service innovation in that segment. The Commission's own decisions confirm the correctness of this view. The Commission's *CPE Interconnection,*[139] *Specialized Common Carrier,*[140] and *Equal Access*[141] decisions stimulated the competition and accompanying innovation that characterizes the CPE and long distance service markets. The CPE market is characterized by an almost unimaginable variety of market-responsive products. Insofar as the long distance service market is concerned, competition, not pricing flexibility in the absence of effective competition, has produced a constantly evolving array of network based traffic management and cost reducing functionalities.

In sum, granting price cap LECs additional pricing flexibility by modifying the new services procedures and cost support rules is not likely to significantly enhance the level of innovation the access service market. Instead, such changes would almost certainly expose end users to exploitative rates, and could be used to inhibit or prevent the development of competition in this market, and thus actually retard the introduction of innovative telecommunications services.

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139. See, *Use of the Carterphone Device in Message Toll Telephone Service,* 13 FCC2d 420 (1968) and *Proposals for New or Revised Classes of Interstate and Foreign Message Telecommunications Service (MTS) and Wide Area Telephone Service (WATS),* FCC Docket 19528, *First Report and Order* 56 FCC 2d 593 (1975); *Reconsideration* 57 FCC 2d 1216 (1976); *Further Reconsideration* 58 FCC 2d 716 (1976); *Second Report and Order* 58 FCC 2d 736 (1976).

140. *Specialized Common Carrier Services,* 29 FCC 2d 870, 970 (1971).

141. MTS and WATS Market Structure, CC Docket No. 78-72: *Notice of Inquiry and Proposed Rulemaking,* 67 FCC 2nd 757 (1978). *Supplemental Notice of Inquiry and Proposed Rulemaking,* 73 FCC 2nd 222 (1979). *Second Supplemental Notice of Inquiry and Proposed Rulemaking,* 77 FCC 2nd 224 (1980). *Report and Third Supplemental Notice of Inquiry and Proposed Rulemaking,* 81 FCC 2nd 177 (1980). *Fourth Supplemental Notice of Inquiry and Proposed Rulemaking (Phase I),* 90 FCC 2nd 135 (1982). *Second Report and Order (Phase II),* 92 FCC 2nd 787 (1982). *Third Report and Order (Phase I),* 93 FCC 2nd 241 (1983). *Notice of Proposed Rulemaking (Phase III),* 94 FCC 2nd 292 (1983). *Notice of Proposed Rulemaking (Phase IV),* 94 FCC 2nd 396 (1983). *Supplemental Order (Phase I),* 94 FCC 2nd 852 (1983). *Phase I Order Modified on Reconsideration,* 97 FCC 2nd 682 (1983). *Phase I Order Modified on Further Reconsideration,* 97 FCC 2nd 834 (1984). Phase I Orders Affirmed in Part, *Remanded in Part sub nom. National Association of Regulatory Utility Commissioners v. FCC,* 737 F.2d 1095 (D.C. Cir. 1984). Cert. denied, 469 U.S. 1227 (1985). *Report and Order (Phase III),* 100 FCC 2nd 860 (1985). *Phase I Order Modified on Second Further Reconsideration,* 101 FCC 2nd 1222 (1985). Affirmed sub nom. *American Telephone & Telegraph Co. v. FCC,* 832 F.2d 1285 (D.C. Cir. 1987).

Baseline Issue 9: Equalization of Regulation for LECs and CAPs

Baseline Issue 9a: Whether our current rules for computing AT&T's exogenous access costs should be revised to equalize the treatment of LEC and CAP access rates in the calculation of AT&T's exogenous access costs.

The Commission should not revise its rules to equalize the treatment of LEC and CAP access rates in the calculation of AT&T's exogenous costs.

The entire question of "flowing through" cost changes related to use of CAP services resulted from LEC concerns that a requirement to treat as exogenous only LEC access price changes would create a bias in favor of CAP access services. In creating the original LEC price cap rules, the Commission concluded that the small scale of CAP services and competition among the interexchange carriers would prevent any actual bias against the LECs: That is still true. Nevertheless, certain changes in the present access services environment have caused the Commission to revisit the issue. As stated in the NPRM, two separate issues exist relative to CAP access pricing flow-through: (1) Flowing through any savings that AT&T may achieve from moving traffic from a LEC to a CAP, and (2) flowing through changes in CAP access prices in the same manner as LEC access price changes are flowed through today. Each issue should be separately addressed.

Flow through of cost changes resulting from moving service from a LEC to a CAP

Exogenous treatment of any cost changes resulting from a decision by AT&T to purchase service from an alternative access provider rather than a LEC would be completely inappropriate. Changes in *LEC* access prices, cost changes that are treated exogenously today, *are the result of regulatory actions outside of the control of AT&T*: Any savings that may arise from LEC access charge reductions are not the result of innovation, increased efficiency, or any other operational activity or strategy on the part of AT&T. Such changes are appropriately treated as exogenous and should continue to be flowed through to ratepayers as long as AT&T continues to be considered a "dominant carrier." Cost changes that might occur as a result of a decision by AT&T to purchase a particular access service component from a CAP rather than a LEC do not fall into the same category: Such changes are the direct result of AT&T initiatives, and cannot be considered to be "exogenous" from AT&T's perspective. Requiring AT&T to treat such changes as exogenous would be the same as requiring it to treat as exogenous any cost changes it might experience as a result of a decision to purchase different relative proportions of various manufacturers' multiplexing equipment, or to treat exogenously any savings it might gain from a decision to lower the thermostats in

AT&T office buildings to reduce heating costs. Clearly, no one could reasonably claim that the cost changes associated with these types of activities should be treated exogenously — and neither should any cost changes resulting from a decision to purchase access service from a provider other than the LEC.

Flow through of changes in alternative access provider access prices.

The logic underlying the Commission's initial decision to require flow through of access rate changes *only* for LECs was premised upon a finding that CAP services represented a very small piece of the overall access market.[142] That condition has not materially changed since the time that the original decision was reached. The AT&T flow-through requirement was designed to reflect a *large* and *measurable* cost change that would not otherwise have been captured by the Price Cap formula. The extent of CAP price changes is, in terms of AT&T's overall access service expenditures, not *large*, nor are such small changes easily *measurable*.

In the recent *AT&T Price Cap Performance Report*,[143] the Commission found no evidence that flowing through CAP price changes would have any effect upon the level of the single remaining AT&T Basket 1 price cap index because CAPs provided such a small portion of the overall access traffic. The *NPRM*, however, points to the Commission's recent decision to *allow* expanded interconnection for switched access as possibly changing the condition that caused it to make its earlier determination that CAP services represented a *de minimus* portion of overall interexchange carrier access service purchases. Current evidence, however, still supports that conclusion. AT&T still continues to purchase 99% of its total interstate access services from LECs — meaning that only 1% presently goes to the CAPs. Although data is not available separately for switched and special access, it is likely that the CAP share of the switched access market (the form of access used by the AT&T Basket 1 services for which flow through is required) is even smaller than 1%. While the steps that the Commission has taken toward fostering competition in the access services market are laudable, they have not had (nor should they be expected to have had) the effect of creating a fully competitive access market overnight. The LECs can be expected to maintain the lion's share of the interstate access market for quite some time to come: Until that condition has changed measurably there is no need to debate the merits of flowing through CAP changes. At this point, the

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142. *See*, Policy and Rules Concerning Rates for Dominant Carriers, Report and Order and Second Further Notice of Proposed Rulemaking, 4 FCC Rcd 2873, 3005, 3020, 3029 — 3030 (1989) *(AT&T Price Cap Order)* and *AT&T Price Cap Order on Reconsideration*, 6 FCC Rcd 665, 673-674 (1991).

143. 8 FCC Rcd 5165, 5168-69 (1993).

discussion is simply about a non-issue, and it may remain so for many years to come.[144]

Baseline Issue 9b: Whether any other rules or policies that relate to LEC price cap regulation should be revised to equalize our treatment of LECs and CAPS, and if so, what the revised rules and policies should be.

There is no reason to equalize the treatment of LECs and CAPs under the Commission's current price cap rules.

The purpose of regulation, price cap regulation included, is to cause a monopoly or dominant firm to behave in a manner similar to what could be expected if it were operating in a fully competitive market. The incumbent local exchange carriers are monopoly service providers,[145] the CAPs most clearly are not. Our analysis of the CAPs versus the LECs reveals that the former generate less than 1% of LEC total access revenues, have assets that are less than 1% of the amount of LEC plant in service, and have less than 1% of the personnel as the LECs.[146] There is simply no economic justification for subjecting these barely emerging competitors to price or cost regulation of any kind. There is clearly no danger of the CAPs wielding monopoly power.

This Commission has a long history of regulating "dominant" service providers at a different level than "non-dominant" competitors. Although AT&T's market share in the long distance market has dropped well below 70%, the Commission has never seen fit (nor should it now see fit) to apply the same type of price regulation to AT&T's competitors that it had to

144. Given the relative status of competition in the interexchange market and the access services market, there is some likelihood that even AT&T Basket 1 services might be removed from Price Cap regulation prior to the time that the CAPs capture a large enough share of the switched access market to warrant further discussion of the flow through of CAP access price changes.

145. Some parties, most notably the LECs themselves, suggest that the LECs face robust competition in many of their markets and that the monopoly has been eroded. That claim, which is advanced to support an ambitious political and regulatory agenda which requires that this fiction be taken as fact, cannot pass scrutiny under any credible economic standard. For a further discussion of the current state of the local exchange monopoly see *The Enduring Local Bottleneck: Monopoly Power and the Local Exchange Carriers*. (Prepared by Economics and Technology, Inc. and Hatfield Associates, Inc. 1994).

146. Data used for calculations come from the following sources: CAP data is the *1993 ALT Report* by Connecticut Research; LEC data is the FCC Statistics of Common Carriers.

AT&T.[147] Those firms that are attempting to compete with AT&T were allowed the freedom to price against AT&T as best they could — and competition in the long distance market has grown substantially. It is quite unlikely that customers would have enjoyed the vigorous and beneficial competition in the long distance market if the Commission had restricted nondominant firms in the same manner that it was necessary to restrict the dominant service provider. To now consider extending some of the terms of LEC price caps to the alternative access providers, when those providers *combined* account for less than 1% of the total LEC market, is ludicrous.

Conversely, the minimal level of competition that the CAPs have introduced into the access environment is without question not of a sufficient magnitude to warrant the Commission changing the rules applicable to the LECs to "equalize" the treatment of LECs and CAPS. The Commission must be sure not to frustrate the work it has been doing in trying to foster competition in the access market by prematurely revising LEC price caps rules so as embrace these nascent competitors.

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147. Although the Commission has ended price cap regulation for all but Basket 1 of AT&T's services, there was a period of time in which all of AT&T's services were included under price caps, while *none* of its competitors services were subject to price or cost regulation.

Baseline Issue 10: Sales and Swaps of Exchanges

Baseline Issue 10: Whether, and how, the process for granting waivers of the price cap rules governing mergers and acquisitions or the price cap rules themselves should be revised so as to prevent unreasonable cost shifting and maintain the efficiency incentives of the price cap plan.

The Commission should not revise it waiver rules at this time.

Appropriately capturing the impact of the "sale or swap" of exchanges under the price cap mechanism is likely to become more important over time. The question posed here goes to the heart of the Commission's "all or nothing" rules for Price Cap carriers, and the advisability of revising those rules. It is our belief that the existing rules should remain in place — the concerns relative to improper cost shifting and "gaming the system" are as valid today as they were at the time the Price Cap rules were first written. The Commission should continue to keep its rule generally in effect and grant individual waivers only as conditions warrant.

The likelihood of an overall increase in the incidence of the "sale or swap" or exchanges makes it important that the Commission begin to evaluate methods of appropriately capturing and reflecting the exogenous costs associated with these activities. In its recently filed *Petition for Rulemaking*[148] the Ad Hoc Committee put forth a proposal to allow competing firms "to bid to provide service at a lower cost (thereby improving overall economic efficiency, and lowering the size of the [USF] fund)," in exchanges to which "high cost" funds are distributed. Other proposals for revamping the universal service funding mechanisms in some manner have been proposed by USTA, MFS, MCI and Teleport. Any changes the Commission may make choose to make relative to universal service funding are likely to impact the relative economics of owning particular exchanges, thereby resulting in greater LEC activity in this area. It is important that the Commission be prepared for this increased activity with a predetermined set of guidelines for the appropriate treatment of the various types of activities related to the sale, swap or purchase of exchanges by both price caps and rate of return carriers.

148. *Op. Cit.*, footnote 4.

Baseline Issue 11: Other Revisions to the Current LEC Price Cap Plan

Baseline Issue 11: Whether the Commission should adopt revisions to the baseline LEC price cap plan in areas other than those specifically discussed in this notice.

The Commission should modify the price cap rules as follows: "Add-back" of sharing revenues should be required; "add-back" of LFAs should not be allowed.

The Commission should take the opportunity provided by this Price Cap review to clarify the price cap rules associated with the "add-back" of sharing and lower formula adjustment amounts. In a rulemaking initiated in the summer of 1993, CC Docket 93-179,[149] the Commission sought comments on a proposal to "clarify" its rules relative to the calculation of rates of return to be used in conjunction with its price cap plan in such a manner that the purpose and function of the "back-stop mechanisms" are not thwarted in the future by unclear rules. No further orders have been issued in the 93-179 proceeding. The rule clarification that was outlined in the "Notice" would have required "add-back" of sharing and lower formula adjustments.

The Commission was right to attempt to nail down the details associated with the implementation of its price cap plan: The confusion relative to the treatment of base period sharing and LFA adjustments which arose in the course of the investigation of the 1993 annual access filings is symptomatic of a need for clarification.[150]

Review of the rules relative to this issue demonstrate that rules do presently exist, they just are not well specified. It was anticipated that in its investigation in CC Docket 93-179 the Commission would come to a decision as to what these existing rules are — unfortunately that has not happened as of yet. In its Comments on the LEC 1993 annual access tariff Direct Cases the Ad Hoc Committee put forth an it interpretation of the existing rules :

> [T]he present rules are not "unresolved" relative to this matter: the present rules *require* add back of prior year sharing revenues and the present rules *make no provisions* for the add back of prior year LFA adjustments.[151]

149. 8 FCC Rcd 14, 4415 (1993)

150. *Id,* para. 3

151. Comments of the Ad Hoc Telecommunications Users Committee in the Matter of the 1993 Annual Access Tariff Filings, CC Docket 93-193.

Clarification of the Rules should be made to require "add-back" of sharing revenues and prohibit "add-back" of lower mark adjustments

Add-back of LFA amounts is not contemplated by the existing price cap rules and should not be allowed under any future rules. LFA add-backs are inconsistent with earnings monitoring under rate of return regulation.[152] Some participants in Docket 93-179 argued that "normalization" is required for rate of return calculations and that "normalization" should apply to lower formula mark adjustments as well as sharing adjustments. NYNEX quoted from Part 61, stating:

> LECs may include adjustments "retargeting the PCI to the level specified by the Commission for carriers whose base year earnings are below the level of the lower adjustment mark".[Section 61.45(d)(1)(vii)] LECs must include adjustments "as may be necessary to reduce PCIs to give full effect to any sharing of base period earnings" required by the Commission's rules.[61.45(d)(2)] [153]

NYNEX's interpretation is incorrect. Rather than supporting NYNEX's position, these excerpts support disallowing add back for lower formula adjustments. For example, the base period PCI adjustments made in the 1992 annual filings to implement sharing and LFAs were made to accomplish very different ends.

- Those revenues that were "shared" in the 1992 filing were prior period earnings (from the 1991 — 1992 period) — therefore it is appropriate to remove them from the new base period (1992 — 1993) rate of return calculations.

- The lower adjustment mark changes made in the 1992 annual filings "retargeted" the PCI to attempt to increase the earned ROR for forthcoming period (1992 — 1993), it would therefore be inappropriate to reduce the base period (1992 — 1993) rate of return calculations to remove those earnings that clearly belong in that period.

The simple fact that both activities are effectuated by an adjustment to the PCI does not mean that they should both be accounted for in the same manner in the following year's rate of return calculations. Reciprocity is not warranted in this instance.

The argument that the Price Cap system would be legally invalid if the Commission did not require the LECs to normalize their rates of return by adding back the effects of sharing and by removing the effects of LFAs is flawed. The link that NYNEX attempted to make

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152. For a further discussion, see the Comments of MCI in Docket 93-179, at 10.

153. See, Comments of NYNEX in Docket 93-179 at 9, footnote 10.

between the court's invalidation of the automatic refund rules in 47 C.F.R. Section 65.700[154] and the adjustment mechanisms under price caps simply does not exist.

Credit Should Not Be Allowed For Below Cap Rates

The NPRM in Docket 93-179 also solicited comments on an add back "credit" for below cap rates. Such a credit would be wholly inappropriate.[155] It must be remembered that the purpose of sharing is to "share base period earnings" — the fact that a given carrier's prices are below the cap should have no impact on that issue.[156] If a carrier earns 14.5% with prices set below the cap it does not mean that ratepayers have any less right to "share" in the base period earnings than if the carrier had its prices set at the level of the cap. The price cap plan as it is structured does not guarantee that sharing revenues are ever actually passed through to consumers. A carrier's decision to price a particular service below the cap is premised upon a number of different considerations: There is no reason why those considerations should have any impact upon the manner in which the total amount of revenues designated for "sharing" are "add-back" into base period rate of return calculations.

Additionally, implementation of a credit for below-cap rates would be unwieldy (if not impossible) to properly administer. Ameritech's comments in Docket 93-179 argued in favor of a credit mechanism; Ameritech provides an example in which the API is $5-million below the PCI prior to a sharing adjustment of $8-million, meaning that the total price reduction required to implement the sharing adjustment is only $3-million.[157] Unfortunately, the situation is not as simple as Ameritech presents it — the following examples add but one small layer of complexity to the overall calculation — it is likely that in reality the determination would be much more complex than the situations outlined below. Assume, for example, that coincident with the $8-million reduction attributable to sharing adjustments there are also other PCI adjustments occurring at the same time to contribute to a total PCI reduction of $12-million. Now prices need to be reduced by $7-million rather than $3-million. Should the $7-million adjustment be reflected in the "add-back" calculation, or should the $3-million be reflected? Assume alternatively that other PCI adjustments occurring coincidentally with the sharing adjustment result in a total PCI change of only $1-million, meaning that the API is still below the PCI and no prices are changed. In that instance, should there be no add-back

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154. *American Tel. & Tel. Co. v. FCC*, 836 F.2d 1386 (D.C. Cir. 1988).

155. See, e.g., comments of AT&T in Docket 93-179, at 4, footnote 6.

156. The "cap" is nothing more than a price ceiling — there is no more reason to regard prices that are set below the cap as being somehow discounted or special than there is to view prices that are set above the lower limit of the pricing band as being too high.

157. See, comments of Ameritech in Docket 93-179, at 7.

at all, or should the $3-million that would have be required absent the other changes to the PCI be added-back?

Baseline Issue 12: Relationship to Other Proceedings

Baseline Issue 12: How the Commission should coordinate the LEC price cap review and any changes in the LEC price cap plan with other proceedings and proposals.

The Commission should carefully coordinate LEC price cap review with its other on-going proceedings.

In evaluating potential modifications to the existing price cap system, the Commission must be very careful not to produce unwarranted impacts upon the goals it is presently pursuing in other proceedings. If, for example, additional pricing flexibility were to be granted as a result of this review, that added flexibility may be used by LECs to frustrate Commission policies regarding, for example, expanded interconnection and open network architecture. As we noted in our recent paper, "Access and Competition: The Vital Link"[158] all elements of the access environment (Part 36, Part 69, Universal Service funding, and the price cap form of regulation) are intricately interrelated. Correction of the various defects in the existing price cap system will support the Commission's objectives in assuring an efficient and, where possible, a competitive access environment. At the same time, however, the Commission should not permit the present proceeding to be used by the LECs as a "back-door" means of accomplishing parochial goals that the Commission has otherwise not accepted.

158. *Op. Cit.*, footnote 4.